

The State of China Fraud in mid-2014

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I. INTRODUCTION

Is China Fraud a “2011 Mindset”?

China Fraud vs. Typical Western Stock Fraud

- Typical Western: real companies with fraudulent accounting
- China: revenue 20% to 99% non-existent

Asymmetry of the China Fraud Business

Bad things happen when investors' capital is used by people who own upside without downside.

Five Moments that Created 2011

- ONP (June 2010)
- RINO (November 2010)
- CCME (January – March 2011)
- LFT* (May 2011)
- Sino-Forest (June 2011)

* not exposed by Muddy Waters

The Aftermath

- Numerous companies “went dark”
- A number of buyouts
- Remaining companies valuations compressed, but many have roared back

Post-Sino Fraud Short Results

Mixed

- HRBN (announced pre-RINO)
- QIHU
- FMCN*
- EDU*
- FU / LLEN
- NQ*

* exposed by Muddy Waters

**II. HAVE CHINA COMPANIES
REALLY CLEANED UP (OR
JUST GOTTEN BETTER AT
FRAUD)?**

More Savvy Responses

- FMCN, Olam (not a China fraud)
- Standard response playbook
- Success depends on a credulous marketplace

Investors Racing to the Bottom

- EDU – Hsieh recording
- VIPS – real world stores???
- Alibaba

“China Inc.” Response Telling

- Never any backlash or criticism of acknowledged fraudsters
- Demonize short sellers and U.S. regulators

III. GOVERNMENTS' ROLES IN CHINA FRAUD

PRC Response

- I wrongly expected PRC government to remain neutral
- After Sino-Forest, government acted to protect frauds
- I believe CCP was attempting to protect officials' interests in HK-listed companies
- HK is collateral damage

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- Intransigence toward SEC and PCAOB

PRC Response – Net Effect

- Western media exposed stunning levels of corruption anyway
- Asymmetrical business became even more asymmetrical
- Officials and princelings likely have significant undisclosed interests in U.S.-listed frauds

U.S. Posture

- Unsure of SEC's current stance
- Exchanges possibly cowed by reversal of NASDAQ decision to delist CleanTech Innovations (July 2013)

IV. AUDITORS' ROLE IN CHINA FRAUD

If We Believe Stock Fraud is a Real Malady...

- Why do so many China frauds persist in our midst?
- Why are auditors, despite their internal access, usually the last to identify frauds?

Relatively Easy to Identify China Company with Fraud Risk

- High DSO
- Few tangible assets on balance sheet
- Highly acquisitive / high capex
- Outsized gross margins, growth
- Unique in reliance on intermediary counterparties
- Often (successfully) entering new businesses
- High revenue or expense concentrations with counterparties
- Unexplained cash in the VIE
- Business models that don't make sense (e.g., reliance on Guanxi Fairies)
- Opacity – especially increasing over time
- **Tax preferences / rates that don't hold up**

High Level Issues with China Auditors

- Auditors generally lack sufficient skepticism
- Audit procedures unsuited for China & EM
- Fraud too widespread
- Auditors pragmatic re incremental liability

THANK YOU!

MUDDY
WATERS
RESEARCH